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conditions have been followed out in practice, and the former custom by which cities and towns secured numerous unsound special concessions has been largely eliminated. New Jersey followed in 1916 with a similar law, the

success of which was indicated above. South Carolina adopted a law, in 1917, following in principle the New Jersey act. The passage of such a measure represents a genuine public decision to adopt an honest borrowing policy.

## Problems of a Model State Income Tax

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**I**F we concede that the quest for uniformity in state income taxes is not too visionary to justify our labors, and turn to the practical work of drafting such a model law, we are confronted with various problems, some general and others involving legal technicalities or matters of administrative policy. It is the purpose of this article to indicate the principal underlying problems and suggest their solution.

### FORM AND PHRASEOLOGY

Let us consider first the matter of form and phraseology. Shall we adopt the language and style of the Wisconsin Act, the New York Act, or that of Massachusetts? Or shall we follow the federal drafting? The latter is obviously imperfect, carelessly worded, often ambiguous. On the other hand, Massachusetts' drafting sounds verbose to a New York resident, while New York's legislative work seems often crude and incomplete to Massachusetts ears. We must recognize, however, that the federal income tax has been applicable to an increasing percentage of the entire population since 1913, that they have become gradually acquainted with its principal requirements and the language of its paragraphs, and that any variation therefrom in future federal income tax acts is likely to be slight. Further-

more, its provisions have been, and will be for years to come, the basis of judicial decisions that would only apply indirectly and questionably to an act embodying entirely different phraseology. Thus an adoption of such different language would be an economic waste of judicial effort. For these reasons, it seems preferable to adopt the federal form and language wherever possible, departing from it only where it is clearly ambiguous or where the change is so slight and so in the interests of good English that no harm can result and possibly some gain may accrue. Such an adoption of federal form and language is far more likely to be acceptable to the states as a whole than the previous efforts of a particular state legislature in this direction.

For the same reason that its provisions have become a matter of fairly general knowledge among the tax-paying public, and the basis of court decisions elucidating and defining these paragraphs, it seems advisable to adopt in the main the federal provisions defining gross income and net income. These paragraphs have been tested over a period of years, cover the subject matter adequately, and have in the main proved equitable. Most of the objections that may be urged against them arise either from faulty administration or from an interpreta-

tion that shrinks from conceding an equitable result not clearly required by the law itself.

#### SHALL THE ACT BE CHANGED?

On certain points, however, inasmuch as the federal department has so definitely adopted certain rules to the contrary, a change in the act itself should be seriously considered. Most students of taxation will agree: (1) That in determining gain or loss from the sale of property, the adoption of a necessary basic date value often works a hardship and creates a fictitious taxable profit, and that, therefore, the use of actual prior cost in lieu thereof should be optional with the taxpayer; (2) that exchanges of property for shares in the organization of a corporation should not be deemed to create taxable income; (3) that the question of whether taxable income is created by exchanges of shares in reorganizations and mergers is not handled upon a satisfactory basis under the federal law. It is further suggested that under a low-rate state tax, the deduction of all interest may safely be permitted, even though incurred in whole or in part in carrying non-taxable securities, since any apportionment in such cases is apt to be arbitrary, difficult and inexact.

A good income tax will in the main accord with good accounting principles, and any divergence should be viewed with suspicion. Perhaps the most striking instance of such a divergence is in the matter of contingent losses and liabilities,—matters which every accountant will insist upon having set up in the balance sheet in the form of reserves, but which the federal authorities, though probably authorized to permit this under their law as a deduction from income, refuse to recognize until the liability is determined by final court decision or

prior settlement between the parties. This applies to all tort liabilities, admiralty claims and many claims in contract for damages. Can such matters safely be included in the list of deductions from gross income? Obviously their inclusion must be so handled that the government will be safeguarded from any abuse of the privilege. This can be accomplished by the adoption of some such provision as the following:—

In the case of taxpayers who keep regular books of account upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities may be deducted, under such rules and restrictions as the tax commission may impose. If the tax commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year, and assess it accordingly.

With the above changes, the federal provisions as to gross and net income may safely be made the basis of a model state act.

#### THE PROBLEM OF SCOPE

Having thus outlined the tax itself, the problems of its scope and incidence must be considered. Shall it apply to all persons who realize income within the state, or shall it apply only to those who are domiciled within the state? Massachusetts has adopted the latter test, Wisconsin and New York the former. The New York problem of "Jerseyites" and commuters from Connecticut is perhaps unique, but most western states would refuse to accept an act that failed to tax the income of eastern capitalists who realize profits within the state in mining or other enterprises. The test of domicile or residence is not an easy one to administer, as Massachusetts has found out. If, however, every state

should impose the tax both upon its legal residents and upon non-residents who earned income within its borders, then there would be two taxes paid upon all income earned outside the state of residence and but one tax upon income earned therein,—an unfair discrimination.

This can only be avoided either by a credit in one state for taxes paid on the same income elsewhere, or by the adoption of the test of domicile as the sole basis for the tax. New York has incorporated the idea of a credit. Such a credit means a waiving to that extent of the right to tax by the state of domicile, and might conceivably affect its revenue seriously.

The committee on a model tax system appointed by the National Tax Conference has suggested as a solution of the problem the imposition of two separate, distinct taxes,—one upon all income by the state of domicile or residence, the other upon income earned within the state by any person, resident or non-resident. Thus, the resident who earned his entire income within the state would pay two taxes therein, while he who earned his income elsewhere would pay one tax in each state. This scheme, while theoretically sound, would be slow of adoption but is more logical than the New York tax credit. States where the non-resident is not much in evidence should content themselves with an income tax based on domicile or residence; others can add to this a so-called "business tax" payable by residents and non-residents alike upon all income earned in business within the state.

#### THE PROBLEM OF INCIDENCE

The problem of the incidence of the tax raises two questions: To what residents shall the tax apply; and how much of their income shall be exempt?

Shall the tax be upon all who are residents for a certain length of time during the year? Shall this be the year when the income was produced, or the year when the tax is payable? Or shall we apply the tax to those residing within the borders of the state on a particular day?

Careful analysis will show that if a period of time is taken as the test, then if this period is one of less than six months, two or more states may each properly claim a tax upon the same income in certain cases. Massachusetts thus claims a tax from every person moving into the state at any time in the first six months of any year, upon his income for the entire preceding calendar year. If this rule were adopted generally, then a person who, in January, 1921, removes from New York to Massachusetts, and again in April removes to Connecticut, from whence he leaves in June to reside in Pennsylvania, would, in theory, be subject to four income taxes upon his entire 1920 income, although the three states whose borders he had crossed would have obvious difficulties in collecting.

Our law, if it is to be a model law, must avoid such overlapping of jurisdiction, and this can be done properly only by taking residence upon a single definite date as the test, such as the date when the return itself is due; for if we were to require at least six months' residence as a preliminary, then many by prior removal would escape taxation in any jurisdiction, a result as inequitable as the double or quadruple tax above illustrated.

#### ANALYSIS OF TAX

This conclusion is supported by an analysis of the true nature of the tax which we are imposing. Such an income tax should not be conceived as a property tax, but as a personal tax

measured by the prior earning power of the individual as a gauge of his ability to pay. We often refer to it in general conversation as a "tax upon income," and such is the easiest everyday conception; but strictly speaking, it is a "tax measured by income." If, then, the state is taxing its residents in 1921 to pay the state or local expenses of that year, the mere fact that this is measured by income of 1920 should not divert our attention from the fact that only those persons who are in the state in 1921 receive the benefits thereof, and should therefore bear the burden. And being thus benefited, the fact that their income was earned in 1920 in a state from which they have removed should not relieve them from tax.

Residence upon a single date, then, either on the first day of the year in which the return is due, or on the due-date of the return itself, should be adopted as the test of incidence. It follows from this that the income of persons who die before such date will escape taxation, if we are to be consistent. To many, the presence of such a hiatus in an income tax seems repugnant, as they feel that income from property should be taxed at all times to someone, with no gap in the case of death. But this view is inconsistent with the theory of a personal tax. It reverts to the idea of a tax upon income as it is being earned, rather than upon the person for benefits later conferred in the year when taxed. In the case of death the benefits cease and the tax should not be imposed.

Within the scope of the tax should be included, if the rate is to be a flat one, individuals, fiduciaries and partnerships. If, however, the rate is progressive, depending upon the amount of income, then the returns of fiduciaries and partnerships must of

necessity be for information only, and the income received from such sources included in the returns of the partners and beneficiaries. In the case of a flat rate with a direct tax upon fiduciaries and partnerships as such, the tax should be regarded as essentially a collection at the source and should be made dependent upon the domicile of the beneficiaries or partners, as the case may be, rather than upon the residence of the fiduciary or the place of business of the partnership. Even if we adopt a progressive rate there will be certain cases where fiduciaries will be directly taxable, as where a person dies after the date selected for the incidence of the tax and before the assessment or payment thereof; also in the case of fiduciaries representing insolvent or incompetent persons.

#### INCOME RECEIVED

Turning now to the point of incidence with reference to the amount of income received, it would seem advisable to adopt the federal exemptions of \$1000 for a single person and \$2000 for a married person living with husband or wife, and an additional \$200 for each dependent. The original recommendation of the Model Tax Committee of the National Tax Conference was for a somewhat smaller exemption, but this was made before the increase in the cost of living had taken place. In view of this increase and for the sake of absolute uniformity with the federal rule, the adoption of these exemptions is urged. It is extremely doubtful whether the placing of a smaller exemption would increase the revenue in proportion with the increased expense of administration. The small returns of income are those which require the most attention and assistance, and expenses can usually be so estimated by a taxpayer that a

tax department, in the absence of exact records, can rarely make an assessment which justifies the expense involved. On the other hand, it is obviously a distinct disadvantage to have one rule for the filing of state returns and a different rule for filing of federal returns, as Massachusetts has learned, and if it can become generally known that any person subject to either law must be equally subject to the requirements of the other, the number of delinquents will be very largely reduced.

Whether the returns should be required upon the basis of gross or net income of a stipulated amount is a question concerning which there has been much discussion. The federal act has always required a certain minimum of net income as the basis of the return, whereas Massachusetts takes as the test the amount of gross income. It is obvious that the use of a net income figure allows the taxpayer in doubtful cases to estimate his expenses, including depreciation, very liberally, and by various errors and misconceptions so reduce the balance that he satisfies his conscience that no return is due. The discovery of such border-line taxpayers is difficult and rarely attempted, with the result that a certain class undoubtedly escapes taxation altogether. On the other hand, the taking of gross income as the test results in the filing of a large number of returns of small businesses in which the net income is substantially less than the exempted amount, and the handling and examination of every such return is a direct administrative expense, with no return therefor.

On the whole, since a state income tax efficiently administered is at the best a somewhat expensive method of raising revenue, involving generally an expense of from one to five per cent of the revenue collected, it would seem

preferable to adopt a test of net income for the reason last stated, even though a small number of taxpayers may escape contributing their small amounts to the reduction of the general burden.

#### METHODS OF ENFORCEMENT

For the enforcement of the act, we have a choice between two methods,—“collection at the source” and “information at the source.” Under the earlier federal acts, “collection at the source” was tried, but the results were so unsatisfactory as to lead to its abandonment in favor of the other method, in later acts. This is now the method of enforcement used in Wisconsin, New York, Massachusetts and elsewhere. While the effect of “information at the source” is a moral one, acting *in terrorem*, this moral force is a very real and valuable one, and the experience of Massachusetts has shown that in addition such information may be made the basis of very important delinquent and auditing work. Therefore, though it involves much waste effort in its preparation and the system is far from perfect in its operation, yet it has a real function to perform, and plays an important part in producing that substantially complete enforcement which alone can keep such a tax upon the statute books.

#### THE ADMINISTRATIVE ORGANIZATION

Our final problem is that of determining the powers and duties of the administrative organization and the method of creating such an organization. This latter involves a choice between direct appointment, subject possibly to confirmation by the highest executive authority of the state, and selection by civil service examination. Massachusetts still clings to the former method, New York, Wisconsin

and (to some extent) the federal department use the civil service test. Under ideal conditions, where political pressure will not be used unduly or unwisely, the Massachusetts method probably results in a better selection of the personnel, as the most essential qualities—tact, courtesy, industry and loyalty—are not such as are disclosed by written examination. However, as conditions generally exist, it is probably wiser to adopt the method of selection by civil service examination, with the understanding that due provision be made for an oral examination as a part thereof, with income tax officials participating therein.

In determining the powers and duties of the administrative officials, we must weigh, on the one hand, the necessity for compelling full and complete enforcement of the law and disclosure of all taxable items (with punishment for negligence and fraud), and on the other hand, the necessity of protecting the public from an over-exacting, bureaucratic, vexatious administration. Shall we, then, give unlimited powers of investigation, audit and re-assessment, or shall we limit these to prevent their abuse? After all, it is of primary importance that the law be effective, that it have sufficient teeth to command respect and obedience; and there is serious danger of its virtual failure if we render helpless the administration machinery. If administrative powers tend to be abused,

public opinion may usually be counted upon to remedy the evil, and we can safely rely upon this and the ordinary good-sense of officials desirous of retaining their jobs, to keep the administration within reasonable limits. Enforcement should not be unnecessarily vexatious, as it too often is in the case of the federal department, but it is more important that enforcement be not lax and casual, nor should we change our method as a remedy where only a change of personnel and administrative attitude is required.

Various other provisions must be included in our model law, such as those providing for distribution of the revenue collected, the exemption of intangible personal property from taxation, secrecy as to the contents of returns, publication of statistics, etc. These are, in part, matters which must be adjusted to meet varying local conditions in the different states. In general, I would point out in conclusion that all of the provisions of such an act should be drafted with due consideration of the local problems involved, since in the attempt to secure uniformity among the states it would often be unwise to ignore these local conditions.

I trust that the presentation of these problems and their suggested solution will make it apparent that our vision of a uniform state income tax among the states is not too difficult to justify our continued endeavors.